

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-542-96
CBMcClure

date: JUL 8 1999

to: Chief, Examination Division, Houston District
Attention: [REDACTED]

from: District Counsel, Houston District, Houston

subject: "Pool of Capital" Doctrine - [REDACTED] Issue

You have requested that we review and offer our opinion on the positions expressed in [REDACTED]'s supplemental protest to the alternative issue asserted with respect to the farmout by [REDACTED] of parts of its interests in Production Licenses [REDACTED] and [REDACTED], in the [REDACTED] offshore [REDACTED], to [REDACTED] ([REDACTED]) and [REDACTED] ([REDACTED]). These production licenses are known collectively as the [REDACTED] interests.

Specifically, you have inquired how the "pool of capital" doctrine impacts the analysis of whether [REDACTED] assignment of parts of the [REDACTED] licenses to [REDACTED] is subject to tax pursuant to I.R.C. sec. 367 and the regulations thereunder. Our advice herein elaborates on our previous advice on this matter, in response to [REDACTED]'s contention that the pool of capital doctrine affects analysis of the farmout transaction.

[REDACTED] on [REDACTED] (effective [REDACTED]) agreed to assign [REDACTED]% of its equity interest in the [REDACTED] licenses to [REDACTED] (which agreed to immediately pass through its rights and obligations to [REDACTED]), in consideration for which [REDACTED] agreed to finance a "[REDACTED]" (which [REDACTED] under the agreements would carry out), up to directly incurred costs of [REDACTED]. The [REDACTED] includes the [REDACTED] as well as a [REDACTED] under which [REDACTED] is the [REDACTED] operator. Thus, the [REDACTED] funded by [REDACTED] was committed to exploration of the [REDACTED] licenses, the [REDACTED] entity [REDACTED] was the [REDACTED] operator performing the exploration activity, and [REDACTED] in consideration for [REDACTED]'s funding of the exploration program agreed to assign to [REDACTED] a [REDACTED] equity interest in the licenses under exploration. The [REDACTED] provides that the parties thereby "establish[ed] a joint venture for the purpose of engaging in

petroleum activities in accordance with the Production License and [said] [REDACTED]."

Under the "pool of capital" doctrine, the lessee of an oil and gas lease which farms out part of its interest in exchange for a third party's agreement to conduct or fund exploration activity on the lease is regarded as having spread the risks and burdens associated with further exploration of the property, rather than as having parted with an interest triggering realization of income or gain. The third party is characterized as contributing to the pool of investment capital available to explore the property. This sort of assignment does not result in realization of income by the assignor, and

[c]ash received [incident to the financing of further exploration] is treated as a contribution by the assignee to the common pool of investment in exchange for an interest in the property, which in turn reduces both the interest and the development or completion costs of the assignor.

Anderson v. Commissioner, 54 T.C. 1035 (1970), citing G.C.M. 22730, 1941-1 C.B. 214 and G.C.M. 24849, 1946-1 C.B. 66.

[REDACTED] did not receive the funds committed to exploration by [REDACTED] without restriction as to their use; these amounts were exclusively dedicated to further exploration of the [REDACTED] licenses by the [REDACTED] joint venture.¹ Characterization of the assignment and farm-in as a "sale" is therefore inaccurate under the pool of capital doctrine, which rests upon general principles of taxation. See, e.g., Fleming v. Commissioner, 82 F.2d 324 (5th Cir. 1936) (taxation . . . can only be on income as distinguished from capital, on the increment of wealth realized by its conversion or by its use in conjunction with labor and not on the original capital), citing Eisner v. Macomber, 252 U.S. 189 (1920). See also Rev. Rul. 77-176, 1977-1 C.B. 77 (no realization of income incident to transfer of working interest in exchange for drilling obligation). [REDACTED] transfer to [REDACTED] of [REDACTED] % of its equity interest in the [REDACTED] licenses in exchange for [REDACTED]'s funding of the [REDACTED] [REDACTED] under the [REDACTED] is not

¹Similarly, [REDACTED] assignment to [REDACTED] was not absolute. [REDACTED] provides in pertinent part that [REDACTED] must promptly relinquish its equity interest and [REDACTED] must promptly assign to [REDACTED] its license interests, should [REDACTED] either fail to complete the [REDACTED] or fail to incur the [REDACTED] for the exploration specified by the agreements.

properly characterized as a sale for tax purposes.

Whether the [REDACTED] assignment of the [REDACTED] licenses to [REDACTED] may be characterized as a sale, however, is immaterial to whether the transfer is subject to taxation under I.R.C. § 367. Section 367 is designed to tax dispositions of foreign-based assets which, had the disposition involved domestic assets, might not be subject to taxation. That the farmout does not amount to a sale does not answer the question whether it triggers taxation under section 367.

Treas. Reg. §§ 1.367(a)-4T(e)(1) through (3) provide special rules pertinent to transfers of oil and gas working interests outside the United States. These sections provide that such transfers shall be considered to be transferred for use in the active conduct of a trade or business, and thus not subject to tax under section 367, provided certain specified conditions are met. The [REDACTED] transfers at issue do not satisfy the specific conditions of Treas. Reg. §§ 1.367(a)-4T(e)(1) through (3). However, Treas. Reg. § 1.367(a)-4T(e)(4) provides in pertinent part that,

[o]il and gas interests not described in this paragraph (e) may nonetheless qualify for the exception to section 367(a)(1) contained in section 1.367(a)-2T relating to transfers of property for use in the active conduct of a trade or business outside of the United States.

Treas. Reg. sec. 1.367(a)-2T(c) provides:

(c) *Property transferred by transferee corporation -*
(1) General rule. If a foreign corporation receives property in an exchange described in section 367(a)(1) and as part of the same transaction transfers the property to another person, then the exception provided by this section shall not apply to the initial transfer. For purposes of the preceding sentence, a subsequent transfer within six months of the initial transfer shall be considered to be part of the same transaction, and a subsequent transfer more than six months after the initial transfer may be considered to be part of the same transaction upon the application of step transaction principles.

This section effectively provides that, even if the taxpayer can establish that the transfers subject to the section 367(a) examination adjustment satisfy the exception to taxation by virtue of the fact that the transferred assets are used in the active conduct of a trade or business, the [REDACTED] transfers nevertheless fail to qualify for the exception, because [REDACTED],

within six months of receiving the [REDACTED] licenses from [REDACTED], incident to the farmout agreement transferred [REDACTED] % of its interest in those licenses to [REDACTED] (subject to the [REDACTED] and [REDACTED]'s funding commitments).

However, Treas. Reg. § 1.367(a)-2T(c)(2) goes on to provide:

(2) *Exception.* Notwithstanding paragraph (c)(1) of this section, the active conduct exception provided by this section shall apply to the initial transfer if -

(i) The initial transfer is followed by one or more subsequent transfers described in section 351 or 721; and

(ii) Each subsequent transferee is either a partnership in which the preceding transferor is either a general partner or a corporation in which the preceding transferor owns common stock; and

(iii) The ultimate transferee uses the property in the active conduct of a trade or business outside the United States.

(Emphasis added.) It is indisputable that the ultimate transferee (regardless of whether the ultimate transferee is considered to be the [REDACTED] joint venture or [REDACTED] alone) uses the transferred property - i.e., [REDACTED] % of the [REDACTED] licenses - in the active conduct of the trade or business of petroleum exploration outside the United States. What is in question is whether [REDACTED]'s transfer (i.e., the "initial transfer" under the regulation) of the [REDACTED] licenses to [REDACTED] was followed by a transfer described in section 721, and whether [REDACTED]' transferee is a partnership in which [REDACTED] is a general partner.

[REDACTED] in the [REDACTED] agrees to assign an undivided [REDACTED] % License Interest in each of the subject licenses to [REDACTED], which passes through the interests to [REDACTED]. I.R.C. § 721 provides in pertinent part that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. [REDACTED] does not literally transfer the [REDACTED] license interests to a partnership; it transfers them to a third party, with which it is engaged in a joint venture. The transfer therefore superficially appears to fail to qualify for the exception to taxation provided by Treas. Reg. § 1.367(a)-2T(c)(2).

However, Treas. Reg. § 1.761-1(a) defines the term "partnership" to include a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or trust within the meaning of the Code. (Emphasis added.) The regulation continues that "the term 'partnership' is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships." Treas. Reg. § 1.761-1(b) defines the term "partner" to mean a member of a partnership.

[REDACTED] and [REDACTED] in entering into the [REDACTED] at the same time entered into a [REDACTED].² Under the terms of the [REDACTED] the parties "establish[ed] a joint venture for the purpose of engaging in petroleum activities in accordance with the Production License and said [REDACTED]." [REDACTED] was appointed and accepted responsibility as Operator under the [REDACTED] (the [REDACTED]), and both [REDACTED] and [REDACTED] under the [REDACTED] were to appoint two members to the joint venture's management committee.

The Tax Court has recognized that oil and gas joint ventures are partnerships for tax purposes. See, e.g., Bentex Oil Corporation v. Commissioner, 20 T.C. 565 (1953). Moreover, the Service has treated oil and gas operations conducted incident to joint operating agreements as partnerships for tax purposes. Rev. Rul. 1958-1 C.B. 324. See also Rev. Rul. 68-344, 1968-1 C.B. 569, Madison Gas and Electric Co. v. Commissioner, 72 T.C. 521 (1979), aff'd, 633 F.2d 512 (7th Cir. 1980). (b)(5)(AWP)

[REDACTED]

(b)(5)(AWP)

[REDACTED]

(b)(5)(AWP)

[REDACTED]

²The [REDACTED] is an Appendix to and forms part of the [REDACTED].

(b)(5)(AWP)

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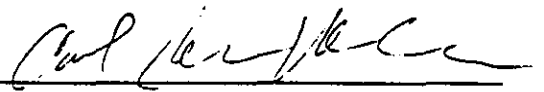
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Please do not hesitate to contact us if you have any

questions regarding the contents of this memorandum, or if you would like to discuss.

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By:


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cc: Ted Jones, Case Manager